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JAPAN-KOREA ECONOMIC RELATIONS

Summary

Lingering animosity from the colonial period has made postwar relations between Japan and the Republic of Korea complex and unstable. On the twentieth anniversary of the normalization of diplomatic relations between Japan and Korea, however, the two countries are moving in the direction of closer economic and political ties. The two are major trading partners and Japan is the largest foreign investor in Korea. Tokyo's exports to Korea consist largely of capital goods, its imports of consumer goods. Korea's rapid economic development has led many to label it a second Japan, and it increasingly finds itself involved in the trade conflict between its two major trading partners.

Introduction

Rapid economic growth during the past two decades has made the Republic of Korea, Japan's nearest neighbor, a significant economic force. With an average annual real growth rate of 8.7 percent since 1962, per-capita income has increased from $87 to more than $2,000. Exports of $26.3 billion last year made Korea the fourteenth-largest exporter in the world.

Extensive economic ties have developed between Japan and Korea, which ranked as each other's second-largest export market after the United States in 1984. Korea accounted for 4.2 percent of total Japanese exports, while Japan's share of Korean exports was 15.7 percent. Japan's direct investment in Korea since 1962 exceeds $1 billion and accounts for nearly one-half of total foreign investment in that country.

On the twentieth anniversary of the normalization of diplomatic relations between Japan and Korea, the relationship between the two countries appears relatively good. In January 1983, Yasuhiro Nakasone made Korea the site of his first overseas trip as prime minister. Korean President Chun Doo Hwan made a state visit to Tokyo the next year, becoming the first Korean head of state to visit Japan. Despite the efforts of political leaders, the historic animosity persists. In a poll that asked which country was friendliest to Japan, South Korea was chosen by only 0.6 percent, compared to 20 percent for China and 3 percent for the Soviet Union. This perception is reciprocated by the South Koreans, who rank the Japanese next to the North Koreans in their own opinion polls.

Historical Overview

When annexed by Japan in 1905, Korea was a backward, feudal economy that had been isolated throughout much of its history. The lack of transportation and communication systems, the absence of a coherent monetary system and government restrictions had retarded the development of a market economy. The colonial government established an ambitious program to develop the peninsula for Japan's benefit. Its status as a food importer led Japan to concentrate on the development of Korean agriculture. The transfer of Japanese agricultural technology to Korea greatly increased production and resulted in large food exports to Japan. The development of agriculture in Korea as well as in Taiwan enabled the Japanese Empire to achieve self-sufficiency in food in the 1930s.

Although the colonial government did not actively promote industrial development until 1930, the establishment of banks and social infrastructure encouraged industrialization. In the 1930s, the policy of promoting self-sufficiency in the Japanese Empire prompted zaibatsu (large conglomerates) to invest in Korea. Japanese capital established large chemical and machinery plants, especially in northern Korea, where there were abundant mineral and energy supplies. Heavy industry accounted for about one-fourth of Korea's exports to Japan by 1935.

From 1912 to 1938, the Korean economy matched the Japanese growth rate of 3.4 percent. Although colonial rule was intended to benefit Japan, the policies pursued encouraged Korea's development. Per-capita consumption is estimated to have increased at an annual average rate of 2 percent, despite a rapid rise in the population. There was also considerable structural change, as the manufacturing sector's share of commodity output increased from one-fourth in 1916 to one-half by 1936.

The transformation of Korea compares favorably in many respects with European colonialism in Africa and elsewhere in Europe. Despite economic development, the repressive nature of the colonial government was a bitter experience for Korea. The lingering animosity has made postwar relations between the countries complex and highly unstable.

With the liberation and division of Korea at the end of World War II, Syngman Rhee became the president of South Korea. The strongly anti-Japanese Rhee resisted American pressure to restore bilateral ties. Negotiations

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between the two countries, which began in 1951, made little progress until the military coup in 1961 that brought Park Chung Hee to power. The priorities of the new government, namely rapid economic growth, finally led to an agreement. Korea's military regime considered economic ties with Japan to be essential to secure new capital for the expansion of the economy. The treaty to normalize relations, concluded in 1965, recognized the Republic of Korea as the only legitimate government in Korea and committed Japan to pay Korea $300 million in compensation and provide another $500 million in loans and credits.

Prime Minister Eisaku Sato's belief that South Korea's security was essential to the security of Japan encouraged the development of working relations between the two countries. The Sato government restricted Japanese ties with North Korea and provided more aid to Seoul than promised in the 1965 treaty. Between 1965 and 1972, Japan supplied Korea with $970 million in grants, credits, and government and commercial loans -- altogether about one-fifth of Korea's total foreign capital requirements during that nation's second five-year economic development plan (1967-71). Moreover, trade increased rapidly, with Japan's exports to Korea rising from $180 million in 1965 to $980 million in 1972 (see Table 1).

Table 1: Japan's Trade with the Republic of Korea, 1965-84

(in millions of dollars)

Year	Exports (f.o.b.)	Imports (c.i.f.)	Trade Balance	Korea's Overall Trade Balance
1965	$ 180	$ 41	$ 139	$ -241
1966	335	72	263	-430
1967	407	92	315	-574
1968	603	102	501	-836
1969	767	134	633	-992
1970	818	229	589	-922
1971	856	274	581	-1,044
1972	980	426	554	-574
1973	1,789	1,207	582	-566
1974	2,656	1,568	1,088	-1,938
1975	2,248	1,308	940	-1,671
1976	2,824	1,917	908	-590
1977	4,080	2,114	1,966	-477
1978	6,003	2,591	3,412	-1,780
1979	6,247	3,359	2,887	-4,395
1980	5,368	2,996	2,372	-4,384
1981	5,658	3,389	2,269	-3,628
1982	4,881	3,254	1,627	-2,594
1983	6,004	3,365	2,639	-1,763
1984	7,227	4,213	3,014	-1,036

Sources: Japan Tariff Association, The Summary Report: Trade of Japan; International Monetary Fund, International Financial Statistics.

With the resignation of Mr. Sato in 1972 and the establishment of diplomatic ties between Japan and the People's Republic of China, Tokyo became less willing to be identified exclusively with South Korea. The abduction of Kim Dae Jung, a leading opposition politician, in Tokyo in 1973 and the assassination of President Park's wife by a Korean resident of Japan also strained relations. Moreover, the policies of Prime Minister Takeo Miki's government reflected a desire to maintain stability on the Korean peninsula while expanding contacts with North Korea.

Japan's opposition parties, particularly the Japan Socialist Party, have opposed closer ties with South Korea, and favored an upgrading of relations with North Korea, with whom Japan does not have diplomatic relations. They object to the military nature of the Seoul government and fear a military alliance linking Japan, South Korea and the United States. Economic links to North Korea, however, have been limited because of Pyongyang's failure to pay back Japanese loans it received in the 1970s. Last year, Japan's two-way trade with North Korea was only 3.5 percent of its trade with South Korea.

Although Korea was graduated from Japan's aid program, Seoul requested a $6 billion aid package in 1981, stressing that it considered such assistance to be a trade-off for Korean security efforts. Tokyo rejected both the amount and the reasoning behind the request. In January 1983, however, the two countries agreed to a seven-year $4 billion aid program. In August 1985, the two countries initialed an accord on science and technology intended to promote transfers of Japanese technology to Korea through the government and other public institutions.

Korea's Economy in 1985

Following the 1980 recession, when real gross national product fell 5 percent and inflation reached 35 percent, Korea's economy grew rapidly, fueled by a doubling in exports to the United States between 1980 and 1984. Real GNP growth from 1982 through 1984 averaged 7.5 percent despite austere monetary and fiscal policies that cut inflation to an annual 2 percent rate. Money supply growth was reduced from 27 percent in 1982 to less than 10 percent in 1984. Public-sector deficits have been reduced by higher indirect taxes, the imposition of a 5 percent tariff on imported oil, and cuts in government spending. Moreover, extensive structural reform in the 25 state-owned corporations has increased efficiency and cut costs.

But the nation is now facing its worst business slump since 1980. During the first half of this year, exports, the basis of much of Korea's economic success, failed to increase above 1984 levels. Economic growth in the April-June 1985 period slowed for the fifth consecutive quarter, increasing only 2.7 percent above the same period in 1984 (see Table 2). The economy must grow at about 6 percent annually just to employ Korea's rapidly increasing labor force. Failure to achieve this level has serious implications for the country's political stability.

For the first half of 1985, real GNP growth was 3.2 percent, less than one-third of the 10.5 percent expansion in the same period a year earlier. Mining and manufacturing output in the second quarter was only 3.1 percent greater than in the April-June 1984 period, reflecting slowing economic

Table 2: Key Economic Indicators of the Republic of Korea

2a: Real Growth Rates

(in percent)

	1983	1984	January-March 1984	April-June 1984	January-March 1985	April-June 1985
GNP	9.5%	7.5%	12.7%	8.8%	3.9%	2.7%
Agricultural Production	6.3	0.3	14.3	-6.5	2.2	0.9
Mining and Manufacturing	10.8	14.3	17.7	15.8	5.2	3.1
Consumption	6.3	5.3	7.4	4.8	5.2	3.1
Investment	16.6	5.6	14.1	9.2	2.6	1.2
Exports	11.6	7.9	17.1	10.3	-0.3	1.6
Imports	9.1	7.6	8.5	9.5	0.6	0.2

2b: Balance of Payments

(in millions of dollars)

	1983	1984	January-March 1984	April-June 1984	January-March 1985	April-June 1985
Current Account Balance	$-1,606.0	$-1,371.3	$-680.0	$-492.0	$-579.3	$-411.7
Trade Balance	-1,763.5	-1,035.9	-643.0	-397.0	-509.6	-41.4
Exports	23,203.9	26,334.6	5,861.0	6,602.0	5,794.6	6,658.4
Imports	24,967.4	27,370.5	6,504.0	6,999.0	6,304.2	6,699.8
Invisible Trade Balance	-434.6	-876.3	-152.0	-234.0	-197.3	-495.7
Net Transfers	592.1	540.9	115.0	139.0	127.6	125.4
Long-Term Capital	1,270.4	2,000.0	580.1	-31.5	275.1	-54.1
Basic Balance	-335.6	628.7	-99.9	-523.5	-304.2	-465.8
Foreign Exchange Holdings (end of period)	6,909.7	7,649.6	6,309.2	6,721.8	6,735.9	6,631.8

Sources: Korea, Economic Planning Board, Economic Bulletin and Monthly Statistics of Korea; International Monetary Fund, International Financial Statisitics.

activity in the United States, which accounted for 36 percent of Korea's exports in 1984. The government's goal for inflated-adjusted growth has been revised downward from 7.5 percent to 5 to 6 percent.

Korea's current account deficit during the first six months of this year was $911 million, exceeding the target of $700 million for the entire year. The decline in the construction industry's overseas earnings, which were off by roughly two-fifths, is a major cause of the current account deficit. Income from such projects, many of which are located in the Middle East, has been falling along with the price of oil since 1983.

The 1985 trade deficit through June of $551 million was actually less than in the same period in 1984, thanks to a larger decline in imports than in exports. The 3.7 percent drop in imports was led by a 16.6 percent fall in purchases of capital goods. Korea's exports have suffered from a high degree of concentration both in product and market. Exports to its major market, the United States, fell 4.1 percent during the first six months of 1985. Shipbuilding, textiles and shoes, which account for nearly one-half of exports, fell 12 percent. One bright spot has been a surge in car exports, which during the first half of 1985 jumped 175 percent. But cars still only account for 2.5 percent of Korea's total exports.

Seoul continued its import liberalization plan in 1984 despite new restrictions on its exports of steel, textiles and color television sets. Last year, 351 items were removed from the import-ban list. Just this past week, moreover, Seoul agreed to set a timetable for lifting import controls on an additional 603 products over the next three years.

Korea's foreign borrowing abroad to finance the current account deficit and to service its debt is expected to reach $6.8 billion in 1985. Although its foreign debt of $45.3 billion is the fourth-largest in the world, Korea's success in international trade has enabled it to avoid the financial troubles that beset some Latin American countries. Its debt-to-exports ratio is only the 16th largest, and the ratio of short-term debt to total debt has fallen. Still, the large debt has led Korea to delay some major projects. At the same time, though, it has encouraged Seoul to gradually ease restrictions on foreign investment since 1980 in order to rely less on borrowing from abroad. Last week, the Ministry of Finance opened an additional 102 business areas to foreign investors and simplified procedures for getting foreign investments approved. This step should accelerate foreign investment, which, at $93 million during the first four months of 1985, is already running 53 percent above the same period in 1984.

Korea's leading indicators give no indication of an upturn in the next few months from the first half's sluggish pace, leading the government to take measures to stimulate domestic demand. Concern over the size of the foreign debt, though, limits efforts to increase domestic demand, since such policies increase imports and worsen the current account deficit, forcing more foreign borrowing. While servicing its debt presents no serious problems at present, reducing the growth of its external debt is a top priority for Seoul. Moreover, the climate for international borrowing is generally less favorable.

The decline in Korea's trade is not unique -- other Asian countries, such as Hong Kong, Taiwan and Singapore, are experiencing a disappointing

export year. But the decline is worrisome in light of the fact that it is occurring before the U.S. trade deficit has begun to shrink, as it must sooner or later, and before the passage of new protectionist measures threatened in the United States. Korea's Economic Planning Board estimates that if the textile bill becomes law, its exports would fall $500 million and growth would contract 0.5 percentage points, rendering 30,000 workers unemployed.

Policies taken by Seoul to stimulate the economy include allowing its currency to depreciate from won 830=$1.00 in January 1985 to won 900. Monetary targets have been increased and a supplementary budget of $289 million has been announced, 80 percent of which will be spent on infrastructure projects. Government expenditures are scheduled to rise by 10.2 percent in the next fiscal year. Moreover, limits on bank lending to the country's 30 largest companies have been loosened and steps to improve conditions for exporters, such as cheaper export finance, have been taken.

Korea's economic prospects, of course, depend on a continued stable political climate. No Republic of Korea head of state has ever left office voluntarily. President Chun has promised to step down in 1988. A second element of risk is the large role of the conglomerates. Korea's big firms tend to rush together into the same new area, aided by cheap loans from the government that deprive the rest of the economy of capital. For example, four major corporations -- Samsung, Goldstar, Hyundai and Daewoo -- have recently entered the slumping semiconductor business. The risk is that the conglomerates will choose to enter the wrong sectors.

Japan-Korea Trade

Trade between Japan and Korea has sometimes been summarized by saying that Japan exports capital goods, such as machinery, to Korea, while importing consumer nondurables like clothing and footwear. Table 3 divides trade into 24 product groups. As expected, Korea, the less advanced of the two, has a trade surplus in both primary products and light industrial products. Textiles and apparel are its major exports to Japan, accounting for about 23 percent of the total. Despite increasing competition from other Asian countries, Korea remains the largest exporter of yarn, fabric and made-up goods to Japan, accounting for about one-fourth of Japan's textile imports. Footwear and apparel, which are also labor-intensive, are other important export products.

The 73 percent share of heavy industrial products in two-way Japan-Korea trade reflects the comparative advantages of the two countries. Lacking natural resources, primary products constitute only a small share of the total. The proportion of light industrial products traded has fallen from 30 percent in 1976 to less than 19 percent in 1984. Competition from less developed countries has made it more difficult to survive in those markets, leading the two countries to focus on heavy industry.

Japan has a large bilateral surplus in heavy industrial products, which account for almost 90 percent of its exports to Korea. Electric and nonelectric machinery is Japan's major export to Korea, with a 40 percent-plus share of all deliveries. Steel exports are important to both countries, although Japan has a large surplus in that category. Other important items are Korean exports of petroleum products and Japanese exports of precision equipment

Table 3: Japan-Korea Trade by Commodity, 1984

(in millions of dollars)

Product Group	Japan's Exports to Korea	Japan's Imports from Korea	Balance	Percent of Two-Way Trade	Intra-Industry Trade Index*
Primary Products	$59.5	$866.2	$-806.7	8.3%	0.87**
Agricultural Products	18.3	819.6	-801.3	7.5	-0.96
Mineral Products	41.3	46.7	-5.4	0.8	-0.06
Light Industrial Products	695.8	1,386.4	-690.6	18.6	0.44**
Textiles	395.8	706.4	-310.6	9.8	-0.28
Apparel	1.0	251.9	-250.9	2.3	-0.99
Leather Products	159.3	67.3	92.0	2.0	0.41
Footwear	2.1	151.8	-149.7	1.4	-0.97
Food Products	16.1	75.6	-59.5	0.8	-0.65
Wood Products	14.3	25.6	-11.3	0.4	-0.28
Printing	20.0	3.1	16.9	0.2	0.73
Tobacco Products	0.2	4.7	-4.4	---	-0.90
Beverages	0.1	2.4	-2.3	---	-0.91
Miscellaneous Manufacturing	86.9	97.7	-10.8	1.7	-0.06
Heavy Industrial Products	6,335.1	1,866.2	4,469.0	73.2	0.67**
Electric Machinery	1,331.1	341.4	989.6	14.9	0.59
Nonelectric Machinery	1,596.4	45.8	1,550.6	14.7	0.94
Steel	1,033.3	468.5	564.8	13.4	0.38
Chemical Products	806.5	111.1	695.4	8.2	0.76
Petroleum Products	81.4	581.1	-499.7	5.9	-0.75
Precision Instruments	513.8	126.7	387.1	5.7	0.60
Rubber Products	338.4	57.1	281.3	3.5	0.71
Nonmetallic Mineral Products	180.3	84.1	96.2	2.4	0.36
Transportation Equipment	223.2	3.7	219.5	2.0	0.97
Nonferrous Metals	129.5	37.7	91.8	1.5	0.55
Metal Products	50.3	4.7	45.6	0.5	0.83
Pulp and Paper	51.2	4.3	46.9	0.5	0.84
Subtotal	7,090.5	4,118.8	2,971.7	100.0	0.64**
Re-exports	136.4	94.0	42.4		
Total	7,226.8	4,212.7	3,014.1		

*This index is calculated using the following formula:

$$\frac{\text{Exports to Korea - Imports from Korea}}{\text{Exports to Korea + Imports from Korea}}$$

If all trade in a product group consists of Japanese exports, the index is 1. Conversely, it is -1 if Korea specializes completely in that group. The closer the index is to 0, the more even the pattern of industrial specialization.

**Weighted average (absolute value).

Source: Japan Tariff Association, Japan Exports and Imports: Country by Commodity.

(although this product group includes video cassette recorders, tape recorders, tape decks and turntables).

Despite Japan's continued bilateral surplus in heavy industrial products, Korea's success in exporting those products is notable. In 1976, for example, Japan imported only $89 million worth of petroleum products from Korea, compared to $581 million last year. Similarly, steel imports rose from $32 million in 1976 to $469 million last year, while purchases of chemical products went from $36 million to $111 million.

The intra-industry trade index in Table 3 indicates a clear-cut pattern of specialization. The overall weighted average of 0.64 means that exports from one country are about five times as great as its imports of items in that category, on average. Rather than a pattern of mutual interdependence between industries in the two countries, there is a vertical relationship, with Japan specializing in heavy industrial goods, particularly capital goods, while Korea specializes in consumer goods.

Excluding the two minor categories of mineral products and wood products, the index shows a relatively even pattern of specialization for only two industries, textiles and miscellaneous manufactures. A closer examination reveals that the pattern of specialization persists within the textile industry. Korean exports of silk, cotton, and knitted and crocheted goods greatly exceed its imports of those items. Japan dominates trade in textile products requiring more capital and large-scale production systems, such as synthetic fibers and metallic textiles.

Japan's trade with countries less developed than Korea shows a pattern that is even more specialized. For example, in Japan's 1978 trade with the six members of the Association of Southeast Asian Nations, it was nearly a 100 percent net exporter or importer in more than half of all trade categories. Japan's trade with the United States shows a less specialized pattern with more intra-industry trade. As the Korean economy develops and as it lowers barriers to imports of consumer goods, the pattern of importing heavy industrial products from Japan while exporting light industrial goods is likely to become more balanced.

Japan's Direct Investment in Korea

Japan is the leading foreign investor in Korea (see Table 4), attracted both by the dynamism of the economy and the availability of inexpensive labor. The steady rise in foreign investment in Korea reflects the liberalization of government regulations beginning in 1980. Major U.S. corporations, including Ford Motor Co., General Motors Corp., General Electric Co. and Texas Instruments Inc., have recently formed joint ventures with Korean conglomerates, and the prospect of foreign competition has encouraged Japanese investment in Korea.

Despite the geographical proximity of the two countries and the volume of trade between them, the level of Japanese investment in Korea is actually quite small compared to its investment in other countries. Of Japan's direct investment in Asia, which accounted for about one-fourth of its worldwide total in the last five fiscal years, Korea ranked fourth behind Indonesia, Hong Kong

and Singapore, with only an 8.6 percent share. Despite recent liberalizations, this low level of investment reflects Korean laws that have limited investment from abroad to prevent foreigners from gaining too much control of the economy. In addition, the vibrancy of the economy, which makes Korea an attractive investment site, also make firms hesitant to provide their technology to an able competitor. The so-called "boomerang effect" is illustrated by the increasing Korean share of world steel trade using technology acquired from Japan.

Table 4: Foreign Investment in Korea by Country, 1962-84

(in millions of dollars)

Country	1962-81	1982	1983	1984	Total	Share
Japan	$633.3	$42.6	$167.5	$163.8	$1,007.2	47.4%
United States	310.3	107.6	53.4	191.0	662.3	31.2
Europe	177.9	9.8	23.4	49.8	260.9	12.3
Others	127.1	27.8	23.5	14.4	192.8	9.1
Total	1,248.6	187.8	267.8	419.0	2,123.2	100.0

Source: Korea, Ministry of Finance

Is Korea a Second Japan?

Korea's economic success and competitive exports have led some observers to label it a second Japan. Korean leaders, fearful of being caught in the crossfire of U.S.-Japan trade frictions, generally reject such comparisons. Of course, there are many similarities between the development paths of the two countries. Korea, like Japan, progressed from exports of textiles to more advanced products like cars and steel. Korean firms have emerged as major competitors of Japan in several areas, such as autos, where a Korean-made car is now the leading import in Canada. Both countries have few raw materials and must depend on imports. In 1984, imports of food, fuel and other industrial raw materials were equivalent to 15.9 percent of GNP in Korea and 7.8 percent in Japan.

But a major difference between the two countries is that manufactured imports are much more important in Korea than in Japan. Except for its dependence on imported raw materials, Japan's industrial sector is able to satisfy almost all domestic demand for manufactured goods. Imports of manufactured goods are equivalent to only 2 to 3 percent of GNP. The self-sufficiency of Japan's industrial sector is a consequence of its being the first country to develop in an underdeveloped region located far from other industrialized countries, as well as its protectionist policies in the 1950s and 1960s.

Korea, in contrast, is dependent on manufactured imports, which amounted to about 22 percent of GNP in 1984. Due in part to its smaller size, Korea's more specialized industrial sector relies on imports of capital goods and

intermediate goods for processing. In fact, the increase in Korea's manufactured exports induces greater imports in these two categories of products. Seoul finds itself in the middle of the U.S.-Japan trade dispute, with an increasing surplus with the United States, its major export market, and an increasing deficit with Japan, from which it buys the capital goods necessary for its exports.

But as exports of consumer goods trail well behind imports of capital goods from Japan, Seoul runs a chronic bilateral trade deficit. Korea's trade deficit with Japan since 1965 represents nearly 90 percent of its total trade deficit during that period. The deficit, however, is more a result of the self-sufficient nature of Japan's industrial sector than of any current protectionism. A 1979 survey by the Industrial Bank of Korea found that the share of restricted commodities in Korea's total exports by country of destination amounted to 18.9 percent relative to Japan, compared with 34.1 and 27.4 percent for the United States and the European Community, respectively. An understanding of the trade pattern between Japan and Korea makes the boomerang problem appear less serious to Japan. Rising Korean manufactured exports induce greater imports of manufactured products from Japan. The loss of market share to Korean firms, either in Japan or in third countries, is at least partially offset by increased exports by Japan to Korea.

For further information, contact Randall S. Jones.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.